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Prioritizing Private Equity Investments in Emerging Markets

Should investors follow yesterday's heroes at depressed values facing a slow economic recovery, or pursue growth – ex-leverage – in new markets that have a higher probability of swift recovery?

The current financial crisis presents tremendous opportunity for those private equity fund managers who are nimble and have capital to invest. Spectacular successes will be achieved by those who can capitalize on market dislocations and mispriced assets. Seeking to recoup the losses of 2008 and profit from current conditions, many pension funds, endowments and other large institutions are actively evaluating secondary, turn-around, mezzanine and distressed debt strategies.

It is in this environment that private equity in emerging markets (“EM”) may finally come into its own. Long considered an arriviste clamoring for the affection of limited partners, EM private equity managers may finally be able to deliver a favorable risk/reward proposition at a time when their peers in North America and Western Europe cannot, or can only do so with seriously increased operating risk at a time when the outlook for corporate profits remains very uncertain.

Secular trends driving rapid development in emerging markets are unaffected by the crisis

Despite the crisis, the same factors driving dramatic changes in global growth, wealth and development over the past several decades remain unchanged from what they were six months – or even six years – ago. By 2008, the emerging markets countries represented 40 percent of global GDP, excluding Australia, Japan and other advanced markets in Asia.¹ Given the current contraction in industrialized economies and continued growth in much of the developing world, EM’s share of the global economy appears set to expand for the foreseeable future.

The causes of rapid development of the emerging world have largely been unaffected by the crisis: educated, growing labor markets unleashed by the implementation of free(er) markets; the development of high-quality, but low-cost manufacturing and services, often through repatriating talented nationals trained at the finest institutions and companies in the West; rapidly improving physical infrastructure in the form of world-class ports, railroads, airports and IT backbones; reformed legal and economic systems that reflect concepts of private property and rule of law; and growing domestic demand from consumers who desire world-class goods and services as strongly as consumers in North America or Western Europe. Of the items above, only consumer purchasing power has been negatively impacted by the crisis as growth has slowed and employment softened.

¹ International Monetary Fund.

Many emerging economies are in healthier shape than those in the industrialized world

The markets outside North America and Western Europe vary considerably in terms of the development of their economies and private equity penetration. Similarly, not to over-simplify disparities in the EM world, we believe that the essential conditions upon which any sustained economic rebound must be based are already evident in many of the emerging markets:

- *Low debt.* With the exception of a handful of countries largely in emerging Europe, the Ukraine and parts of Latin America, leverage is far lower across all categories of emerging market borrower than in the industrialized nations. Public and private sector debt in the US, UK, and Japan, for example, is over 400% of GDP (and growing), whereas it remains at less than 200% of GDP in the majority of emerging markets.²

Tight banking sector regulation in emerging markets, recently cursed for hamstringing growth, is now seen as a blessing that protected many countries from investing in securitized products that few clearly understood. Over the past decade, private-sector lending generally has been more cautious in the developing world: the loan-to-deposit ratio in China fell from 110% in 2007 to less than 70% through 2007, while in the United States it grew from 80% to over 100% during the same period.³

Similar trends exist in many other nations throughout Asia, Latin America, Africa, the Middle East, where banking systems have remained relatively stable and are now in a position to support economic growth with limited government intervention. In Turkey and South Africa no bank has received government equity, and in Russia and Brazil household debt to GDP is under 15 percent. Parts of emerging Europe and the former Soviet Union are exceptions, but it would be misleading to paint the region with a broad label, given the relative health of countries such as the Czech Republic, Poland and Slovakia, which are not facing the same vulnerability to credit and liquidity challenges as some of their neighbors.⁴

- *Depreciating currencies.* Although they have recently begun to recover, EM currencies have fallen sharply against the US Dollar since the start of the crisis. There are notable exceptions, such as in China, where exchange rate controls have allowed the Renminbi to appreciate modestly.

In the short term, depreciating currencies should favor emerging markets; companies that relied on exports now benefit by being able to lower their prices into key markets. Over time, however, this trend may reverse as government debt in the industrialized economies increases the prospect of inflation following the unprecedented explosion of the monetary base, and as portfolio inflows return to EM, of which there are now even early positive signs. In sum, on valuations alone, buying opportunities in emerging markets can be at least as attractive for US Dollar investors as those in developed markets, at least in the near term.

² International Monetary Fund and Templeton.

³ September 2008 data from Global Investment Strategy, BCA Research.

⁴ Moody's.

- *Low-cost manufacturing and services.* The export machines that many emerging economies became were built initially around reasonable quality, cheap products. Over time, however, companies in these markets have been able to develop high-quality goods while maintaining a cost advantage over their counterparts in the industrialized nations, an advantage driven in part by accessible labor, but also by other factors such as proximity to natural resources, aggressive investment in infrastructure, plant and equipment. Today, many emerging markets companies are in the enviable position of being the low-cost producers of high-quality products, which should allow them to weather the current economic crisis better than their competitors in the industrialized nations.
- *High real growth rates.* A common argument in favor of emerging markets has been strong real growth rates that have been fairly consistent as to levels and dispersion for the past several years. Although GDP growth has slowed across all EM markets – most notably Eastern Europe, developed Asia, and parts of Latin America – in most markets it remains on track to outpace GDP contractions in developed economies, and in many cases by a wide margin. This economic expansion has supported growth in per capita income, which in turn has catalyzed consumer demand across all emerging markets.⁵ Over the long term, domestic demand for goods and services within EM may support important structural changes as industries reorient products and services away from export markets.
- *Government stimulus.* Many emerging markets governments have responded to the current crisis with a mix of relatively well-focused stimulus packages and other programs designed to help their economies recover quickly from the shock of the financial crisis and the structural imbalances that contributed to it. Because these countries generally are not pre-occupied with recapitalizing failed banks, can have significant sovereign funds at their disposal, and maintain considerable fiscal/monetary policy latitudes, they have been able to implement a mix of immediate measures to stimulate consumer demand (particularly among the low income segments of their populations) as well as to implement longer-term efforts to improve domestic infrastructure.

We contend that these fundamental factors, when combined with longer-term secular trends that favor continued economic development in emerging markets, will help certain emerging markets to recover in advance of – and at a more rapid pace than – the major industrialized economies.

Promising environments for private equity

Growth and recovery alone do not make a good private equity market, but they certainly help. Necessary preconditions for a sustained recovery include a legal and cultural framework that supports private enterprise and property rights; options for liquidity through mergers and acquisitions and initial public offerings; and, as we now see in contrast to the excesses of the West, a private equity industry that is managed by talented and responsible professionals who can invest third-party limited partner

⁵ See *World Economic Outlook*, from the International Monetary Fund.

capital in a prudent manner. With respect to each of the foregoing factors emerging markets have made substantial progress over the past decade.

To the credit of the International Finance Corporation, European Bank for Reconstruction and Development, the Asian Development Bank, and their counterparts at the other international financial agencies – all of which were early and ardent supporters of private equity in emerging markets – there now is widespread acceptance within the emerging markets private equity industry of basic principles of good governance, transparency, and socially responsible investing. We also see that all major emerging markets have made great strides in developing legal frameworks and procedures that support private enterprise and property, including in some cases full WTO membership, notwithstanding corruption and limitations on civil liberties that still exist in some quarters and must be factored into investment planning. Transitional and candidate status with EU and OECD also has played an important role for several EM countries.

Liquidity at exit, or a lack thereof, has been listed among the greatest concerns about private equity in emerging markets. The reality, however, is that these markets have made excellent progress in this area as well, largely driven by growth in M&A and IPO activity. In fact, of the top ten IPOs in 2008, only one occurred in the United States; eight were in greater China, Brazil, India, Portugal, Saudi Arabia, and Turkey, and a majority of all IPO activity was outside North America and Europe.⁶ Despite a slowdown in the last half of the year, over \$550 billion of M&A activity was concluded in Asia alone in 2008.⁷

While transactions are down sharply in the first part of 2009, emerging markets should quickly regain their footing, supported in part by domestic institutional investors that have remained un-invested throughout much of the recent boom period and have accumulated significant resources derived, in stark contrast to Western economies, from high domestic sector savings ratios and foreign reserve accumulation.

In key markets throughout Asia, Latin America, the Middle East, the oil-producing nations of the former Soviet Union and even parts of Africa, state-managed pension and sovereign wealth funds, are now determining how to build portfolios of domestic and global assets. Much as US institutions prefer to invest closer to home in markets with which they have some cultural affinity, these institutions often prefer to focus their initial investments on their own domestic markets. (This view in some way has been exacerbated by US efforts to limit foreign investment in certain sectors and to curb the number of visas available for travel and work in the United States.) The presence of domestic institutional capital to support the early return of IPOs, debt markets and private equity – especially in China, India, parts of Latin America and South Africa – should further support conditions for continued PE activity in these markets.

All of these developments have supported a rapid growth in the number of private equity funds active in emerging markets (over 550 have been raised since 2006 in Asia alone), which now provides institutional investors with a more than sufficient universe of funds from which they can build a high-quality, diversified portfolio. Each sub-market across the emerging world has a number of managers that have been active for nearly a decade or more and that have gone through a full cycle of investing and

⁶ Renaissance Capital LLC.

⁷ Thomson Reuters and EMAlternatives analysis.

returning capital to investors. We are also seeing more EM sector-focused activity and an increasing range of distressed and credit products offered.

Through the end of 2008, institutional investors responded favorably to the growth in EM private equity, committing nearly US\$ 200 billion since 2004 to private equity funds active across the full range of geographies, and regional and country-specific strategies.⁸ The fund managers, like the markets in which they are active, vary greatly by style, track record and form. As a consequence, it is a granular understanding of emerging markets that makes the opportunity so exciting, but also so challenging. Each individual submarket is facing its own set of challenges and opportunities following on the crisis, driven by a unique combination of exposures to commodities, currencies, industry composition, trading partners, stage of economic development, and government policies. Dedicated expertise, either in-house or outsourced, is essential.

This view then naturally affects the investment choice between opportunities in Western vs. emerging markets.

Yesterday's heroes vs. unlevered growth in new markets with a higher chance of swift recovery

The current questions for institutional investors include whether the recovery will come early and at what pace in Asia and possibly Brazil before that in the USA in 2010, and whether the extreme falls in valuations seen in certain EM countries also offer the chance to generate abnormally large short-term profits from investing in PE style strategies, broadly defined. A secondary question will be the sustainability of the recovery and the macro-economic view one takes of the EM economies vs. developed markets. Regardless of the near-term outlook, a sustained shift in global economic activity toward EM appears unabated by the crisis.

Comparisons between Western and EM opportunity should weigh differently the leveraged vs. relatively unleveraged opportunities for return that exist in each of the markets. The Western proposition is still predicated on the use of mezzanine, distressed debt and equity for re-organizations, and in many cases on the assumption of heavy liabilities, including funded debt and unfunded social entitlements. In the EM world this is not the case. In mezzanine, for example, EM focused funds are tantamount to senior-term lenders and can look forward to improving EBITDA coverage ratios. In distressed, the current emphasis on Western defaults ignores in part real estate and corporate assets to be sold by Western banks in Asia and parts of emerging Europe for which there are only a limited number of specialized buyers.

Comparisons should also weigh seriously the heightened operating risk associated with Western turn-arounds and distressed debt-for-conversion deals in Western markets; not only is financial risk compounded by operating and continued recessionary risks, but the very political and legal environment in Europe, for example, is making such transactions more costly and more difficult to implement. Even in the United States, there is a potential for backlash against techniques that would have been swifter to execute in prior recessions.

⁸ Emerging Markets Private Equity Association.

Misalignments of interest also present themselves as another area of risk present in Western private equity markets and largely absent in the emerging markets. Funds active in large buyouts, and even more recently venture capital, have written down assets or surrendered equity in restructurings to such an extent that the prospect of carry payment to the GPs has gone. The stability of some Western PE firms combined with changes in taxation and regulation contrasts sharply with the opportunities among EM GPs to grow assets under management and remain in the carry in local currency terms, thereby enjoying a stable outlook for their respective teams. This adds, in our view, further contrast to the Western private equity proposition relative to the EM opportunity, at least in the short term.

As to secondary private equity prices, there clearly is a large volume of heavily discounted paper on offer. Pricing soon will no doubt narrow from today's absurd bid-offered spreads. The volume of pure EM secondary paper is still light in comparison to US and European buy-out LP positions, but this will change within several years given the recent pace of EM commitments. In situations where the GP is already well known, selective purchases of stakes in funds may have considerable merit, but the question of the basis of the GP valuations, and the timing and pace of economic recovery required to justify the entry prices and to yield liquidity over the next several years can only be answered on a case-by-case basis.

Conclusion

In this environment, EM private equity has earned the right to be a meaningful component of a well-diversified private equity program. Discussions will naturally continue as to whether EM remains a steady 10 percent of a typical program or is expanded over time to reflect EM's 40 percent (and growing) share of the global economy.

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